

Economic Outlook

United States 1982

December 1981

Overview

After a prolonged period of economic difficulty in the United States, Ronald Reagan was elected President, largely on a promise of wide-ranging economic reform. The initial question was whether an economic program of the type Mr. Reagan envisioned could be moved through Congress. With most of that program now in place, national attention has shifted to the immediate and long-term effects of the Reagan plan.

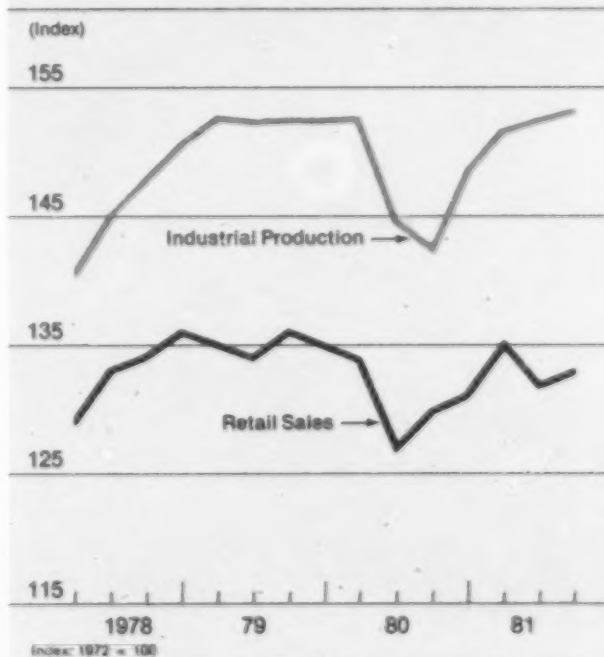
The Administration has set forth several key goals, including higher economic growth, lower inflation, increased military spending, and a balanced national budget. To achieve these goals, the Administration has brought about substantial changes in government spending and tax programs. However, if the economy behaves according to historical patterns, these goals are likely to be contradictory, and some degree of compromise will be necessary.

In 1982, the primary trade-off will be between lower inflation and higher real economic growth. The U.S. inflation rate is expected to continue its downward movement, a trend fostered by the restrictive monetary policy of the Federal Reserve. In 1982, the Consumer Price Index will rise 8 to 8.5 percent, down from an estimated 10.4 percent in 1981 and 13.5 percent in 1980.

Monetary policy that has helped to reduce inflation also has kept interest rates high. While the economy was able to stagger along through most of 1981 under the weight of high interest rates, restrictive policy has finally taken its toll. In the final months of 1981, a general economic weakness was evident throughout the U.S. economy. Real economic growth in 1981 will be about 1.8 percent. The current downturn will continue into early 1982, but as interest rate pressures ease, economic activity will begin to strengthen. In 1982, the real Gross National Product (GNP) of the U.S. economy will decline in the range of zero to 1 percent.

The near term holds some hard choices for the Administration, monetary authorities, and legislators in Washington, as the nation faces the challenges of a deepening recession and the impossibility of balancing the federal budget by 1984. Yet, continued resolve is crucial as efforts proceed to strengthen the U.S. economy following years of high inflation and stagnation. The index of industrial production in the third quarter of 1981 was barely higher than the level it reached in the first quarter of 1979. At the same time retail sales, adjusted for inflation, were below the levels of 1978. (See Figure 1.) A substantial dose of patience and sacrifice is required. Further, the challenge is to avoid a precipitous reversal of policy and adhere to responsible action so that the policies so recently established have a fair chance for success.

FIGURE 1 INDUSTRIAL PRODUCTION INDEX AND RETAIL SALES INDEX 1978-1981



THE U.S. ECONOMY

High interest rates—the result of restrictive monetary policy—threw the economy into a holding pattern throughout most of 1981. The strengths of some sectors of the economy were offset by declines in the sectors most sensitive to interest rates. The net result was little change in overall economic activity. Primarily, the weakness in the economy was concentrated in the auto and housing sectors.

In the final months of 1981, however, this weakness began to spread far beyond those sectors and undermine the strength of the economy as a whole. Any doubts as to whether the economy's performance should be labeled a "recession" were resolved. The real output of the economy during the fourth quarter of 1981 is expected to show a significant decline.

Because a recession is a cumulative process in which negative factors feed on themselves, it is seldom possible to predict accurately its depth or duration. Nonetheless, the nature and cause of this latest recession provide clues to its probable configuration.

The principal cause of this recession is high interest rates, which are largely attributable to restrictive monetary policy. High interest rate levels have led to large declines in the interest-sensitive sectors of the economy, and the resulting negative effects on employment and incomes are now creating a softening in overall consumer demand. An inventory imbalance has emerged, and the need to work off excess stocks will lead to additional cutbacks in production.

The key question is how far down this cumulative process will carry the economy before its natural recuperative powers lead to an upturn. It appears that the current recession will be of about average severity, with a peak-to-trough decline in real GNP of around 2 to 3 percent. A more severe decline seems unlikely. The main factor arguing against a more severe drop is falling interest rates. Rates have already declined from their recent highs and will drop further during the first half of 1982. This will reduce the major slowing force on the economy and allow some strengthening of demand.

The economy will not turn around immediately, partly because it takes time to reverse downward momentum once begun, and partly because it will take time to work off the inventory imbalance. But by mid-year, the economy should begin a recovery. The ensuing upturn is likely to be relatively weak by historical standards. While monetary policy will undoubtedly ease from its recent extremely restric-

tive stance, the Federal Reserve's determination to lower the rate of inflation by limiting growth of the monetary aggregates will keep real interest rates at relatively high levels. This implies a weak recovery at best, a prolonged downturn at worst.

The beneficial impact of monetary restraint on inflation, and the growth-enhancing effects of fiscal policy provide the prospect for a stronger economy in the years ahead.

Consumption—No Longer the Locomotive

Household spending has played an unusual role in the cyclical behavior of the economy during the past few years. Throughout 1978 and much of 1979, spending was robust despite weak growth in household income. That behavior was partially attributable to the low cost of borrowing created by a combination of high inflation, high tax rates, and the low returns on savings.

Beginning in 1980, consumer spending reverted to more normal patterns with consumption expenditures rising more slowly than incomes. These changes are attributable to an unwinding of inflationary expectations—the "buy now to avoid higher prices tomorrow" psychology—combined with incentives to save that have been provided by very high real interest rates. During 1982, the reductions in marginal tax rates that took effect in October 1981 and the additional reductions scheduled for mid-1982 will further increase incentives to save.

**Table 1 Selected Economic Indicators
For the U.S. Economy 1980-1982**

	1980	1981	1982
	(Percent Change)		
Real GNP	-0.2%	1.8%	-0.9%
Consumer Price Index	13.5	10.4	8.2
Nominal GNP	8.8	11.1	6.7
Personal Consumption	16.7	11.2	8.8
Consumer Durables	-0.2	10.4	7.2
Plant and Equipment	5.8	10.5	3.2
Investment			
Residential Structures	11.2	0.3	-0.3
Investment			
Exports	20.8	7.9	4.3
Imports	18.1	8.5	7.0
	(Volume—millions of units)		
New Passenger Car Sales	9.1	8.7	8.9
Total Housing Starts	1.3	1.1	1.2
	(Percent of work force)		
Unemployment Rate	7.1%	7.6%	8.7%

Bank of America estimates for 1981; forecasts for 1982.

These changes in consumer spending habits, when combined with relatively weak income growth, will result in a rise of real consumption expenditures of about 1 to 2 percent in 1982. Real income growth was boosted by the first phase of the Administration's tax cut, but this reduction will do little more than offset inflation-induced increases in income taxes and increases in Social Security taxes, set for January 1982. Not until the second round of marginal tax rate reductions, scheduled for July 1982, will personal incomes significantly rise.

Consumer spending patterns also will be affected by changes in relative prices. Direct purchases of energy—gasoline, fuel oil, and natural gas—will continue to decline in constant-dollar terms. The general shift away from energy-intensive goods will persist as consumers adjust to the large energy price increases of the past few years. A modest increase in home purchases will generate some increase in the sale of home-related durable goods, such as furniture and refrigerators.

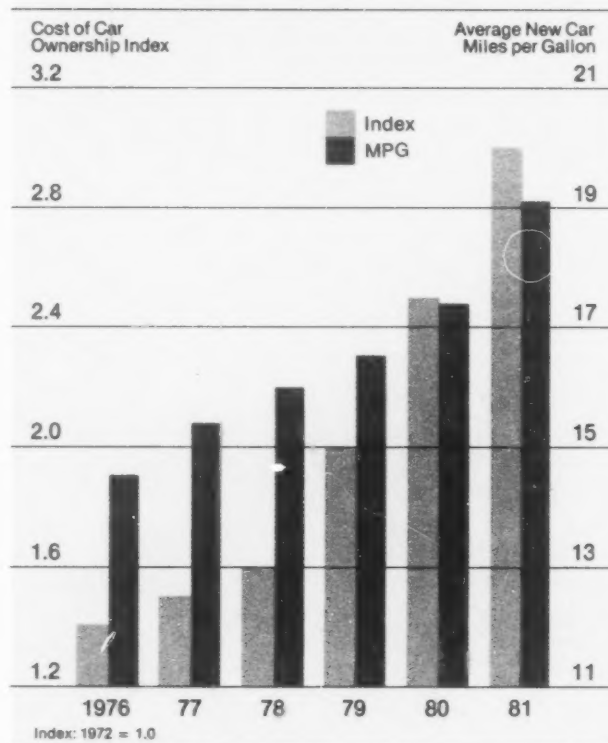
Automobile sales will benefit from the declining cost of credit and modest increases in gasoline prices. Demand for autos has been held below its trend growth rate during the past two years by adverse economic conditions. The result is a pent-up demand that will surface as the economy improves. New auto sales are expected to remain at around 9 million units, little changed from 1981. (See Table 1.)

The trend growth rate of demand for automobiles has declined in recent years, largely because of slower growth in the driving-age population and high energy prices. Throughout much of the 1980s, the young adult population will decline, and growth in the driving age group will slow. Also, consumers have reduced automobile budgets by turning to smaller and more fuel-efficient new cars and have extended the life of currently owned automobiles. (See Figure 2.) Unless the costs of car ownership rise far more slowly than anticipated, a major jump in demand cannot be expected. Americans have made a fundamental shift in their new car purchase patterns and driving habits. These behavior changes will not be rapidly reversed and are expected to be evident throughout the 1980s.

Business Fixed Investment—Will Improve in Late 1982 After Slowing Early in Year

Business investment has managed to hold up well during a period of generally slack economic activity. In fact, the business fixed investment proportion of output has risen over the past three years. Although business investment declined through most of 1981, its share of output remained at 11 percent, a substantial increase from the 10 percent average of the past 25 years.

FIGURE 2 COST OF CAR OWNERSHIP INDEX AND AVERAGE MILES PER GALLON 1976-1981



The decline in business fixed investment in 1981 partly reflected high financing costs and a low level of internally generated funds. In addition, as the economy weakened, spending plans were scaled back or deferred.

The 1981 corporate tax cut will significantly strengthen investment incentives. The new tax program includes an increase in the investment tax credit and a dramatic shortening in the periods over which capital goods may be depreciated. The effect is to compress the period in which an investment pays for itself, thereby increasing the returns on capital goods and raising internal cash flow. The stimulative effects on investment will begin to appear by the end of 1982. While the initial effect will be slight, because of the lags in formulating and financing investment decisions and a further lag in implementing actual spending, the longer-term impact should be considerable.

In the near term, the stimulative effects of the tax changes will be overpowered by the negative effects of high interest rates and declining output. As a result, business fixed investment will decline through the first half of 1982. Subsequently, investment growth will rise, buoyed by a stronger economy, improved cash flow, lower interest rates, and the greater tax incentives.

Inventories—No Major Imbalances

Declining sales are creating an inventory imbalance, with stocks rising relative to sales. This will force future cutbacks in production, not only to match the reduced rate of sales, but also to work off the excess inventory stocks. Barring a major collapse of sales, however, the inventory imbalance is likely to be relatively mild, with inventory levels restored to a normal relationship to sales within one or two quarters.

Businesses have held a tight rein on inventories, partly because of uncertainty about the economy and partly because of the high interest cost of holding inventories. This cautious policy has helped to prevent fluctuations in the economy during the past two years from turning into severe declines. It also is an important reason why the emerging weakness is unlikely to turn into a major downturn similar to that which occurred in the 1973-1975 period.

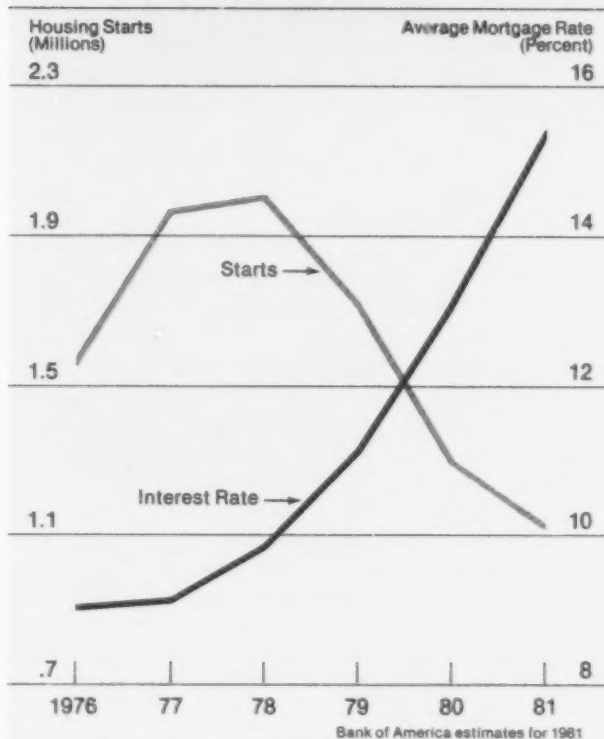
The inventory correction will likely be completed by mid-1982. The subsequent rebuilding of inventories will provide a positive source of growth. Inventory investment will receive some additional stimulus as declining interest rates induce businesses to raise the desired ratio of inventories to sales.

Housing—Still in Weak Condition

The housing sector of the economy has been decimated by high interest rates. (See Figure 3.) New housing starts peaked at slightly more than 2 million units in 1978 and have declined since, falling to an expected level of about 1.1 million units in 1981. Over the past three years, the annual level of housing starts has averaged 1.4 million units. During this same time, the underlying demand for housing—largely determined by growth in the population—rose at a rate of around 2 million units per year, resulting in a pent-up demand averaging 600,000 units per year. This demand for housing will emerge as cyclically adverse economic conditions improve. The decline in interest rates expected for 1982 will not be great enough to provide a substantial boost to housing. Total U.S. residential housing starts will be in the 1.1 to 1.3 million unit range.

Financial institutions that have traditionally financed the housing industry and home purchases are experiencing a period of intense and significant change. In the past, these institutions could draw upon a stable, low-cost base of deposits for mortgage lending. However, rising interest rates and increased competition for deposits—especially from money market funds—have drawn

FIGURE 3 RESIDENTIAL HOUSING STARTS AND AVERAGE MORTGAGE INTEREST RATES 1977-1981



resources away from banks and thrift institutions. In an effort to maintain deposits, these lenders have countered with new instruments—Money Market, Small Savers, and All-Savers certificates—and their costs of funds have risen sharply.

Increasingly, deposits once held in stable, lower-yielding passbook savings accounts are being moved to the new higher-yielding, interest-sensitive categories of deposits. For savings and loan associations, for example, the proportion of interest-sensitive deposits rose from 17 percent in early 1979 to 64 percent in mid-1981. The trend toward higher-cost deposits will continue as the interest rate ceilings on consumer deposits are gradually removed and as households increasingly take advantage of higher-yielding savings instruments.

This higher cost of funds—and some portion of the risks for lenders arising from a more volatile interest rate environment—will be passed along to borrowers. While funds will be available to support greater demand for housing, borrowing costs will be higher, and innovative mortgage instruments will be increasingly utilized. But the transition to the altered financial environment is not yet complete. Until new loan instruments are fully developed and gain acceptance, they will not be a major boost to the housing market.

To help potential homebuyers overcome the obstacle posed by high interest rates, lenders are developing and introducing new mortgage instruments. Appearing in the market now are the Graduated Payment Mortgage, which is designed to reduce loan payments during the early years of a mortgage; the Adjustable-Rate Mortgage, which generally has an initial interest rate below that of a fixed-rate loan but which may be adjusted periodically; and the Equity Participation Loan, in which the borrower shares any price appreciation with the lender. The new loans being developed generally provide both an important avenue for increased home purchases and greater protection for lenders from rising interest rates.

Other elements of the housing market also are undergoing change. During much of the 1970s, as inflation surged and mortgage interest rates lagged, the real after-tax cost of borrowing fell. At the same time, housing prices increased sharply and rapidly. The resulting gains from home ownership were unusually large, creating an additional motivation for home purchase. To the traditional demand for housing based on the need for shelter was added a demand for housing based on investment.

The latter demand is now disappearing under the impact of high interest rates and declining inflation. In the late 1970s, high inflation and low mortgage interest rates often created a negative cost of borrowing. With mortgage rates nationally averaging 16 percent and inflation running about 8 percent, the real cost of mortgage borrowing has risen to 8 percent. It would require an extremely pessimistic view of the course of inflation to justify a speculative purchase at this rate.

U.S. International Trade—Better Near Year-End

The U.S. balance of payments has steadily improved over the past few years, primarily because of the increased price competitiveness of American exports. That improvement came to a sudden halt in mid-1981, largely due to the dramatic appreciation in the value of the dollar that began in late 1980. During 1981, the value of the dollar rose 25 percent, returning to its 1972 levels and reversing nearly a decade of decline.

The rebound of the dollar has created a deterioration in the nation's balance of payments that will last through the first half of 1982. Higher prices for U.S. goods, combined with weak recoveries in the economies of major U.S. trading partners, will lead to a slower growth of exports. At the same time, lower import prices will stimulate the growth of imports to the United States.

The situation would be worse if it were not for the improved energy position. A weak worldwide

petroleum market will keep increases in the price of oil very modest. Also, continuing energy conservation efforts will actually lead to a slight drop in the volume of oil imports. As a result, the total fuel import bill should remain almost constant in 1982 and 1983—in stark contrast to the 30 percent increase recorded in 1980.

The rapid appreciation of the dollar was based on several factors. Interest rates in the United States increased relative to rates in other countries, inducing an inflow of capital investment. Slowing U.S. inflation improved the price competitiveness of goods produced in the United States. Finally, investment funds were shifted to the dollar as international uncertainties increased.

During 1982, as U.S. interest rates ease downward, capital inflows will weaken, and demand for the dollar will decline. The result will be a mild depreciation of the dollar in 1982. In turn, this will strengthen the price competitiveness of U.S. goods, setting the stage for greater growth of exports in late 1982 and beyond.

Inflation—In Single Digit as Downtrend Continues

The unwinding of inflation that began in the past year will continue into 1982, with inflation averaging about 8 percent for the year. Much of the recent decline has reflected the reversal of shock factors that had driven inflation temporarily above its trend rate. Chief among these reversals is the stabilization of oil prices. During the 1979-1980 period, the energy component of the Wholesale Price Index rose 78 percent, while energy alone added 1.8 percentage points to the Consumer Price Index (CPI) in 1980.

But during the past year, the rate of increase in energy prices moderated substantially, with actual declines appearing in the price of imported oil. While OPEC attempted to maintain price levels by cutting production, demand fell even more as real growth slowed in importing countries, and consumers continued to reduce energy consumption in response to past price increases. This trend will continue in 1982, with the rate of increase in the energy price component of the Wholesale Price Index declining to 5 to 7 percent from around 21 percent in 1981.

As economic activity strengthens, the growth of demand for energy will rise, but only slightly, primarily because real economic growth will be relatively weak, and continuing efforts to conserve energy will slow demand expansion. In fact, energy conservation efforts—in response to previous price increases—will continue for several more years even if there are no further hikes in energy prices.

This phenomenon is perhaps most obvious in

the driving patterns of American consumers. Real consumer spending for gasoline dropped more than 6 percent in 1980 and should fall another 4 percent in 1981. Gasoline expenditures are expected to drop another 3 percent in 1982. These declines reflect the steady gains in fuel economy of new cars and an increase in the average fuel efficiency of the nation's total stock of automobiles.

Another factor that suggests slower energy price inflation in 1982 is the completion of the country's domestic oil-price decontrol program. When the decontrol process began, domestic prices—which were at levels below world prices—had to rise rapidly to achieve parity with market rates. Now that parity has been reached, domestic prices will rise only in line with world prices.

Mortgage interest rates have been another major contributor to the inflation rate, adding nearly 2 percentage points to the CPI in 1980. Because mortgage interest rates impact the price indices with a lag, mortgage rates continued to push inflation higher even after the general level of rates had peaked. A decline in mortgage rates in 1982 will significantly contribute to the reduction of inflation. The Bureau of Labor Statistics, which tracks price changes, has announced its intention to alter the housing component in the CPI beginning in 1983. The effect will be a more reliable indicator of actual changes in the cost of living.

The removal of these extraordinary factors provides welcome, but essentially temporary, relief from inflation. Fortunately, the underlying trend rate of inflation is moving down. In the long run, this trend reflects both the restrictive monetary policy of the past two years and expectations of future restraint. But more immediately, this trend reflects a slower growth in average unit costs, both of labor and of capital.

The rate of wage increases has already moderated and, in the near term, will be held down by the pressure from high unemployment. The absence of an increase in the minimum wage and the reduction in personal income taxes will also temper wage increases. A more modest rise in Social Security taxes in 1982 will slow the growth of total labor costs. On the other hand, there will be a tendency for wage hikes to match price increases. Wage gains have lagged behind prices since 1978, and the effort to catch up will continue to put upward pressure on wages. The net result of these contradictory pressures will be a slower rate of increase in wages in 1982.

But compensation per hour will still rise about 8 to 9 percent for the year. Productivity growth will not pick up until late in 1982 and will actually decline for the year as a whole, adding to overall cost pressures. The combination of higher costs and price increases of about 8 percent implies a

very real profit squeeze. Unit labor costs, which account for around two-thirds of total unit costs, will rise about 9 percent. Average total unit costs will rise somewhat less, since the corporate tax cut will significantly reduce the growth of unit capital costs. Thus, the growth of unit costs puts a floor under inflation for 1982.

Interest Rates—Bet on Continued Volatility

Interest rates will gradually trend downward through at least the first half of 1982, but rates will remain volatile, and the downtrend will be interrupted by sporadic increases. By mid-1982, interest rates will face renewed upward pressure as economic activity picks up and government borrowing demands rise.

Volatility in rates is virtually assured by the Federal Reserve's continuing emphasis on controlling bank reserve growth. In the past, monetary authorities tended to match shifts in the demands for credit with accommodating changes in bank reserves. While this policy helped to stabilize interest rates, it did so at the cost of less control over bank reserves and money growth. This changed two years ago when monetary authorities began to place greater emphasis on stabilizing the rate of growth in the nation's money stock through increased stability in the growth of bank reserves. As a result, shifts in demand for available capital are now translated into larger movements in interest rates. The result has been, and will continue to be, greater volatility of interest rates.

The potential for new increases in rates—an issue of overriding concern to the financial markets—arises from a possible clash between monetary and fiscal policies. With the federal tax cuts exceeding spending reductions in 1982, the federal deficit and the government's borrowing requirements will remain high through the first half of 1982, rising even higher after mid-year when an additional reduction in personal tax rates takes effect. If monetary policy remains restrictive, the result might be another round of interest rate increases.

Historically, there has been an inverse relationship between federal government deficits and interest rates. (See Figure 4.) Most often, as deficits have risen, interest rates have declined. The reason for this past relationship is twofold. First, most increases in the federal deficit have occurred when economic activity was weakening. The consequent loss of tax revenues tended to raise government borrowing requirements. But the slack economy also tended to lower the private sector's credit needs, so that changes in government and private sector credit demands usually offset one another.

In addition, under the Federal Reserve's pre-1979

practice of seeking to stabilize interest rates, it tended to buy part of the increased government debt, thereby increasing bank reserves and the supply of loanable funds. The net result was a decrease in the total demand for loanable funds relative to the available supply.

In 1982, however, the private sector is positioned for some growth that will increase credit demand. At the same time, the Federal Reserve's commitment to lowering the rate of monetary growth will preclude it from purchasing much of the government-issued debt and force the government into private capital markets. The result could be rising demands for credit combined with slack growth in the supply of credit and, thus, another round of rising interest rates.

Certainly, upward pressure is likely to be exerted on interest rates by mid-1982. However, several factors will help to moderate—or may even negate—any increases. First, lower inflation will reduce the growth of total dollar demands for credit. Second, as the economy expands weakly, the private sector's credit demands will rise slowly through most of the year. Finally, the private sav-

ings rate is expected to rise in 1982, increasing the supply of loanable funds.

The personal savings rate is expected to rise from its very low level. Stimulus will come from some growth in income as the economy slowly improves and from the scheduled mid-year personal tax cuts. Consumers are typically slow to adjust their spending patterns in response to changes in income, and the initial result will be an increase in savings. In addition, the increase in real, after-tax interest rates created by declining inflation and marginal tax reductions have substantially raised the incentive to save.

Business tax reductions will have a similar effect on corporate savings. Accelerated depreciation will increase the flow of internally generated funds and reduce the need for external financing. This will impact both the total supply of savings and the volume of credit demands. The net result of these factors will be a downtrend in interest rates through at least mid-1982, followed by an upward movement at that time, but a resumption of the downtrend thereafter.

Policy—Still Some Doubts

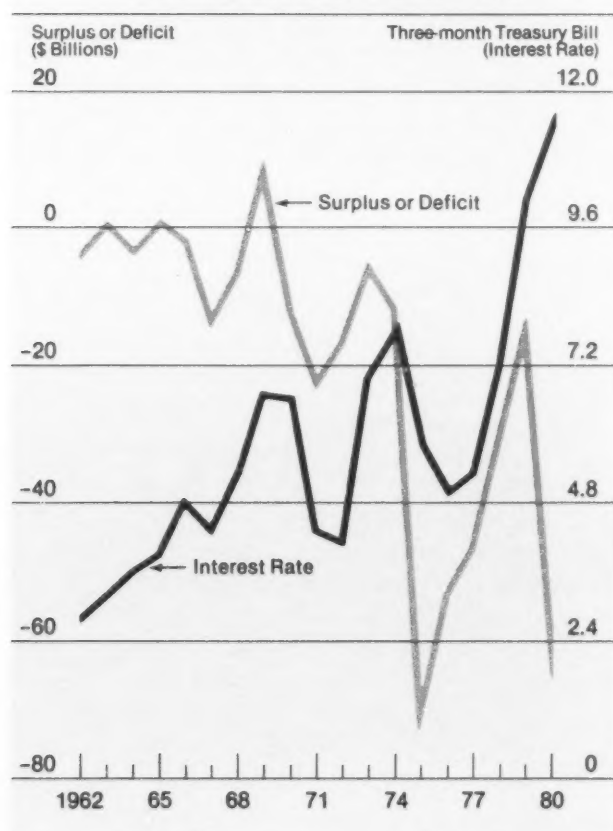
Since a primary goal of the Reagan Administration is to change the long-run paths of real economic growth and inflation, it is not surprising that fiscal and monetary policies have shifted dramatically. Growth in the money stock was reduced in 1981, and continued restraint is likely through 1982. The growth of federal spending has been reduced from its long-run trend.

These policies will eventually raise real growth and lower inflation if they are sustained. But there is concern that the short-term costs of these policies will prove too great, forcing their abandonment before their positive long-run effects appear.

The improvement in the underlying inflation rate is recent and still fragile. The gains made so far could easily be lost through a premature easing of policy or through new inflationary shocks arising, for example, from additional turmoil in the Middle East or major crop failures. The Federal Reserve is maintaining restrictive monetary growth to lock in the gains already made and maintain the conditions necessary for additional gains. The problem is that the monetary growth rates being pursued are not consistent with much real growth. Normally, a prolonged period of restraint, with weak growth, is required to lower inflation.

This raises the possibility of a policy reversal, which is a major concern to financial market participants. Doubts about the long-term inflation trend are a primary reason why long-term interest rates have remained high. The Federal Reserve has

FIGURE 4 FEDERAL BUDGET DEFICIT OR SURPLUS AND THREE-MONTH TREASURY BILL RATE 1962-1980



begun anti-inflation programs before. But each time, the economic costs have proven to be too high, and the monetary authorities have bowed to political forces demanding an eased policy. So each time, a short period of monetary stringency was followed by a prolonged period of stimulus. The result has been a corresponding rise in inflation.

Doubts also remain about the staying power of fiscal policy. The multi-year tax and spending cut program was designed with a long-run focus in an effort to change private sector expectations about the total economic environment, including the growth of government spending, the level of associated taxes, and the basic relationship between the government and the private sector.

The current problems facing the Administration arise from setting overly ambitious goals. The tax cuts are very large, totaling \$45 billion in 1982 and \$96 billion in 1983. Federal spending has been cut for 1982, and additional cuts are promised for the years beyond. But unless a stronger economy produces more tax revenues than expected, even these reductions will leave large deficits.

There also are grounds for skepticism about the spending cuts promised after 1982. Administration plans imply essentially no growth in real federal spending through 1984. This is to be achieved with substantial increases in military spending, while protecting the "social welfare net." But with these two areas accounting for approximately two-thirds of the federal budget, the remaining one-third would have to decline substantially in real terms in each year.

The near-impossibility of achieving these goals implies some revision of fiscal policy, if not in 1982, then beyond. The changes are likely to include slower growth of defense, more rapid growth of total spending, and some increase in taxes.

So there are grounds for skepticism, though compromise does not mean total retreat. A major economic calamity could, of course, force abandonment of the entire thrust of fiscal and monetary policies. But barring this eventuality, changes in fiscal policy are likely to involve a change in dimension, rather than the basic direction, of policy. The economic benefits would appear more slowly and be smaller, but they would still be present.

The Federal Reserve also is likely to maintain the basic thrust of monetary policy. Monetary

authorities have shown surprising determination over the past year, holding to restrictive policy even in the face of skyrocketing interest rates and a no-growth economy. Second, and more important, the Administration supported the Federal Reserve in 1981 and is likely to continue to provide the political support needed to maintain restraint over the next year. The Administration has little choice. If the monetary authorities give up and allow monetary growth to accelerate, the fight against inflation would be lost. That could lead to a loss of confidence and political support for the rest of the Administration's program. Supply-side economics would be abandoned without truly being tried, and the effort to change the entire government-private sector relationship would be aborted.

Finally, the Administration and the Federal Reserve must view this as their best opportunity to permanently change the path of inflation. So they both have powerful reasons to look beyond the near term for long-run gains. Should the economy be afflicted with severe ills in 1982—a major decline in output or interest rates surging to new highs—the costs might yet prove too great to bear. But excluding such developments, monetary policy is likely to remain on a restrictive course, and the basic thrust of fiscal policy will remain basically unchanged.

The economy has already experienced considerable trials. The level of real GNP in 1982 will be less than 1 percent above its level in 1979, making three straight years of very weak performance. The index of industrial production at the end of 1981 was only slightly above the level it reached in the first quarter of 1979. Real retail sales are still below their 1978 levels.

The effects of monetary restraint, just beginning to appear in the underlying inflation rate, will show increasing benefit in 1982 and beyond. The growth-enhancing effects of fiscal policy will be small in 1982, but will provide the prospects for stronger real economic growth in the years beyond. Should monetary or fiscal determination falter at this critical point, the costs that the economy has already borne will have been for nothing, and policies with the promise of an economic rejuvenation will be abandoned without being given a chance for success.